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SENSITIVE

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SUBJECT: Philippines 2009 Economic Wrap-up and 2010 Way Ahead

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SENSITIVE BUT UNCLASSIFIED

¶1. (SBU) Summary: The Philippine economy is poised for moderate growth in 2010 after avoiding most of the effects of the world recession in 2009. Although buffeted by two extremely damaging storms in the final trimester, the Gross Domestic Product (GDP) expanded overall in 2009, while neighboring economies in the region contracted. The Philippine stock market's main index grew over 60 percent, foreign reserves are at a record high; foreign direct investment is rebounding, the local business community continues to build and invest, and remittances are increasing. The banking sector is sound, and the government's fiscal deficit is manageable. Spending on the May 2010 presidential elections is also set to boost the economy and create jobs. However, inefficiency, corruption, misdirected government and private spending, high population growth, and other impediments will continue to constrain growth and prosperity, and will inhibit efforts to reduce poverty for the foreseeable future. End Summary.

Economy Growing Despite Natural Disasters

¶2. (SBU) The Philippine Gross Domestic Product (GDP) grew approximately 1.4 percent in 2009, and will more than double that rate in 2010, according to World Bank and Asian Development Bank (ADB) estimates. The Philippines avoided most of the effects of the global financial crisis because it is less dependent on international trade than other economies in the region, and did not suffer unduly when demand from the United States and other trade partners contracted in 2009. These growth figures take into consideration the damage caused by two large storms in September and October, which resulted in USD four billion in losses and reduced 2009 GDP by nearly half a percentage point. Poverty, which already afflicts one-third of the Philippines' 90 million people, increased by one half of one percent due to the damage caused by the storms. However, the energetic response to these disasters by individual Filipinos, as well as domestic and international charities, donor nations and multilateral development banks resulted in a large injection of cash into the economy that helped cushion the economic downturn and promote reconstruction of houses, farms and businesses. The World Bank estimates that growth in 2010 could actually exceed its pre-disaster estimates, largely due to spending on disaster-related recovery and reconstruction.

Budget Deficit Growing But Manageable

¶3. (SBU) Another result of the natural disasters is a larger-than-anticipated 2009 budget deficit. A fall in imports reduced collections by the customs bureau, and revenue-eroding measures passed by Congress, such as tax breaks for minimum-wage earners and businesses affected by the storms, further cut government income. Special tax exemptions for favored sectors or projects added to the government's revenue woes, and unexpected spending on rescue and relief efforts pushed the government further into the red. However, the overall deficit, when fully tabulated, is unlikely to exceed four percent of GDP in 2009, which is considered manageable by most macroeconomists and is substantially less than the fiscal deficits of the United States and Japan, which were approximately 10 percent of GDP in 2009.

Good Financial Management

¶4. (SBU) The Philippine government (GRP) has financed its deficit by taking advantage of low-interest borrowing from world capital markets flush with cash. It has a debt portfolio balanced between short-, medium- and long-term obligations, which has helped it avoid liquidity crises by spreading out repayments. Its debt offerings have been oversubscribed on a regular basis, which allows it to pay lower interest rates to the many investors bidding for its bonds. The government, expecting interest rates to rise in 2010, has likely saved millions by pre-financing much of 2010's anticipated budget shortfall with this low-cost domestic and foreign capital. Finance Secretary Teves, who the Financial Times Group named best finance minister in Asia in 2008, has also obtained concessional loans from

the Asian Development Bank to finance infrastructure projects, and was the first to take advantage of the ADB's counter-cyclical or stimulus spending loan offering in 2009. The Philippine Central Bank is conservatively managed and well regarded, and although it suffered currency exchange losses from its moderate interventions in the market, it increased its investment profits and reduced expenses in 2009. It is expected to maintain relatively low interest rates through most of 2010, which will further stimulate the economy by reducing startup costs to new entrepreneurs and allowing lower-cost expansion of existing businesses.

Campaigning and Other Growth Engines

¶5. (U) Spending on the May 2010 presidential and congressional campaigns has already begun, and will provide an estimated half point boost to the GDP by increasing consumption and providing jobs. The three major presidential candidates are seen as relatively pragmatic in terms of economic policy, which has helped business sector and investor confidence. Several economic sectors are booming, such as business process outsourcing (BPO), which grew over 20 percent and employs hundreds of thousands of mostly young Philippinos in call centers. Banking and financial institutions have increased profits, and growth in construction and real estate is driven in part by remittances from overseas Philippine workers, which grew by about four percent in 2009 and are expected to show even stronger growth in 2010. A new law allowing the establishment of Real Estate Investment Trusts (REITs) will attract additional investors into the housing market, and offers incentives to spur construction of low-cost housing.

Trade Down, But Showing Signs of Recovery

¶6. (U) The value of exports and imports of goods dropped between 20 and 30 percent in 2009. Part of the reduction in imports was caused by lower world oil prices, but the main drag on trade was weak global demand for the Philippines' primary exports of semiconductors and electronics. However, industry associations reported moderate growth in this sector by the end of the year due to renewed demand, and some analysts see growth up to 10 percent in 2010. Texas Instrument's plant in Baguio is ramping up chip production and may increase sales enough to fill the gap in export value created by the

mid-year closure of an Intel chip plant. Its neighbor in Baguio, U.S. company Moog Systems, is expecting to hire more workers as demand for its aviation hydraulic/electrical components increases with the rollout of the Boeing 787.

Stock Market Rebounds; Investment Climate Improves
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¶7. (SBU) The Philippine Stock Exchange index -- which closed down 48% in 2008 -- gained 63% in 2009. Foreign portfolio capital flows reversed from a severe outflow in 2008 to a moderate inflow in 2009 - a turnaround that may top one billion dollars. Many investors, both foreign and domestic, seeking higher yields than in U.S. or European markets, earned substantial profits in Philippine stocks and bonds. Although investment is still hampered by constitutional limitations on foreign ownership of businesses, and judicial processes are torturously slow and subjective, the overall investment regime has improved. Congress passed a modern renewable energy law that offers investment incentives; protection of intellectual property rights improved incrementally; and the Central Bank eased procedures for businesses remitting profits out of the country. The government has also responded to Embassy efforts to mediate several investment disputes involving U.S. companies, and quickly resolved a major case in the power generation sector late in the year. Foreign direct investment, although down for the year, continues to flow into dynamic sectors, such as power generation, transmission and distribution, BPOs, real estate and consumer goods.

ASEAN FTAs Enter Into Force

¶8. (U) The Philippines is one of six members of the Association of Southeast Asian Nations (ASEAN) that moved towards free trade by eliminating duties on more than 99 percent of products on January 1,
¶2010. On the same date, the ASEAN-China Free Trade Agreement, and the ASEAN-Australia-New Zealand Free Trade Agreement entered into

full force. The new free trade area will rival the European Union and the North American Free Trade Area in terms of value and surpass those markets in terms of population. The effects of these agreements will not likely be apparent for months or even years, but they will certainly increase trade, lower prices to consumers, and increase business opportunities throughout the region. However, Philippine manufacturers will have to compete with low-cost producers in China and elsewhere in the region, and are already discussing the use of anti-dumping rules and other trade remedies to reduce expected competition. These agreements may also reduce the competitiveness of U.S. agricultural products in the Philippines and the region (reftel B).

Not All News from 2009 Was Good

¶9. (SBU) The long-term trend is for manufacturing to move out of the Philippines towards lower-cost countries such as Vietnam, Indonesia and China, but this is a gradual movement that will occur over decades. However, the global financial crisis/world recession accelerated this process in 2009. Intel closed its semiconductor plant after 35 years in-country, and Goodyear also shut its tire plant after 53 years of manufacturing in the Philippines. The ADB estimates that, besides the half percent overall poverty rate increase in 2009 caused by natural disasters, the country's slow long-term rate of poverty reduction has brought about a net increase in the absolute number of poor people since 1990. The Philippines also declined in several competitiveness indexes, with respondents complaining about deficient infrastructure and corruption. In addition, new barriers have cropped up in agricultural trade, affecting U.S. exports. The sudden emergence of price controls on fuel and food reminded entrepreneurs that the government does intervene in markets in ways that affect profits and undercut investor confidence. And finally, companies continue to become entangled in investment disputes. The resultant judicial processes are costly and slow-moving, with officials often susceptible to political or economic influence.

Prospects for 2010

¶10. (SBU) For the short term, the key players in the Arroyo Administration's economic team, such as the secretaries of Finance, Agriculture and Trade, have told us they will stay in office until the May elections. This may help restrain government spending intended to influence voters during the elections, and will likely mean sensible management of the economy for the first trimester. The Central Bank, which is apolitical, will remain under the same management and will continue its cautious approach of containing inflation and intermittently intervening in the market to prevent wild fluctuations in exchange rates. Portfolio capital will continue to buoy the stock and bond markets, although yields will not match those of 2009. Exchange rates are likely to remain stable, especially if the U.S. dollar remains weak, and remittances will continue to offer a steady flow of foreign exchange and boost consumption. The Millennium Challenge Corporation reselected the Philippines as eligible for a compact in 2010, which could boost confidence and result in an inflow of several hundred million dollars dedicated to infrastructure and revenue management if an accord is reached. The possibility of reaching a peace accord with rebels in the resource-rich island of Mindanao would also create business opportunities and further improve investor confidence. Local business tycoons indicate they will continue investing in their own country, and significant development aid from multilateral development banks, non-governmental organizations and donor nations will continue to flow. And finally, meteorologists say the El Nino weather phenomenon may result in fewer and weaker typhoons affecting the Philippines in 2010.

Comment

¶11. (SBU) Although there is a strong element of uncertainty to any economic forecast, there are enough indicators and trends to suggest that 2010 will be a relatively good year for the Philippine economy. However, there remain many pitfalls that will continue to constrain growth. Investor confidence, always precarious, could vanish quickly if political instability were to become widespread. The volatile art of politics is closely entwined with economics in the

Philippines, so any growth in 2010 will be influenced greatly by the conduct and results of the elections, as well as the natural disasters that regularly afflict this archipelago. End comment.

Kenney